



**DEPARTMENT OF INSURANCE, FINANCIAL  
INSTITUTIONS AND PROFESSIONAL REGISTRATION**

P.O. Box 690, Jefferson City, Mo. 65102-0690

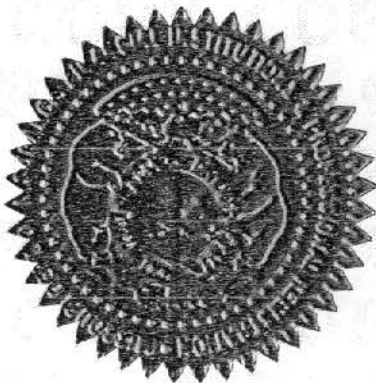
RE: Examination Report of Cornerstone National Insurance Company as of December 31,  
2007

**ORDER**

After full consideration and review of the report of the financial examination of Cornerstone National Insurance Company for the period ended December 31, 2007, together with any written submissions or rebuttals and any relevant portions of the examiner's workpapers, I, Linda Bohrer, Acting Director, Missouri Department of Insurance, Financial Institutions and Professional Registration pursuant to section 374.205.3(3)(a), RSMo., adopt such report. After my consideration and review of such report, workpapers, and written submissions or rebuttals, the findings and conclusions of the examination report are incorporated by reference and deemed to be my findings and conclusions to accompany this order pursuant to section 374.205.3(4), RSMo.

Based on such findings and conclusions, I hereby ORDER Cornerstone National Insurance Company, to take the following action or actions, which I consider necessary to cure any violation of law, regulation or prior order of the Director revealed by such report: (1) implement, and verify compliance with, each item mentioned in the General Comments and/or Recommendations section of such report; (2) account for its financial condition and affairs in a manner consistent with the Director's findings and conclusions.

So ordered, signed and official seal affixed this August 29, 2008.



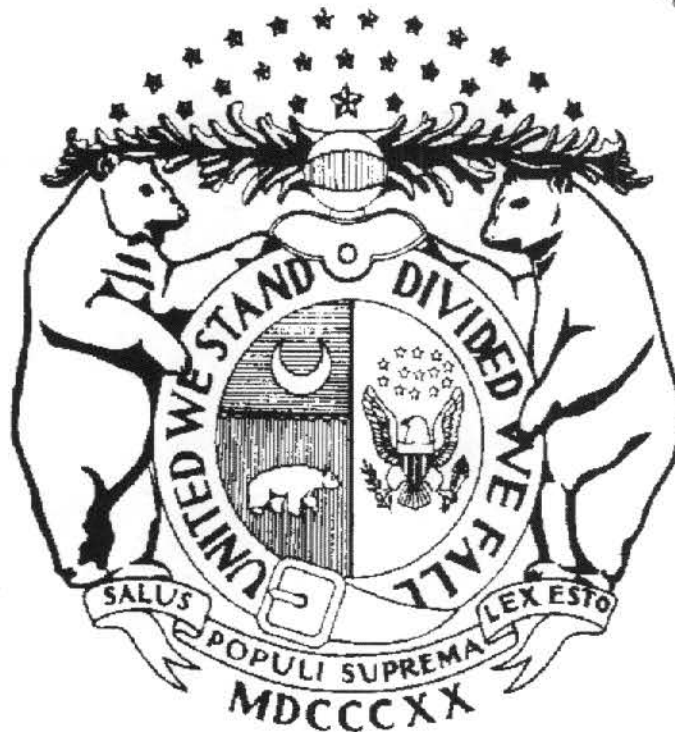
*Linda Bohrer*

Linda Bohrer, Acting Director  
Department of Insurance, Financial Institutions  
and Professional Registration

REPORT OF THE  
ASSOCIATION FINANCIAL EXAMINATION OF  
**CORNERSTONE NATIONAL  
INSURANCE COMPANY**

AS OF  
DECEMBER 31, 2007

**FILED**  
SEP 09 2008  
DIRECTOR OF INSURANCE  
FINANCIAL INSTITUTIONS &  
PROFESSIONAL REGISTRATION



STATE OF MISSOURI  
DEPARTMENT OF INSURANCE, FINANCIAL INSTITUTIONS  
AND PROFESSIONAL REGISTRATION  
JEFFERSON CITY, MISSOURI

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Columbia, Missouri  
July 18, 2008

Honorable Alfred W. Gross, Commissioner  
Virginia Bureau of Insurance  
Chairman, Financial Condition (E) Committee

Honorable Merle Scheiber, Commissioner  
South Dakota Division of Insurance  
Secretary, Midwestern Zone, NAIC

Honorable Linda R. Bohrer, Acting Director  
Missouri Department of Insurance, Financial Institutions  
and Professional Registration  
301 West High Street, Room 530  
Jefferson City, Missouri 65101

Ladies and Gentlemen:

In accordance with your financial examination warrant, a full scope association financial examination has been made of the records, affairs and financial condition of

**Cornerstone National Insurance Company**

hereinafter referred to as such, as CNIC, or as the Company. Its administrative office is located at 3100 Falling Leaf Court, Suite 200, Columbia, Missouri, 65201, telephone number (573) 817-7000. This examination began on January 28, 2008, and concluded on the above date.

**SCOPE OF EXAMINATION**

**Period Covered**

The prior full scope association financial examination of CNIC was made as of December 31, 2004, and was conducted by examiners from the State of Missouri representing the Midwestern Zone of the National Association of Insurance Commissioners (NAIC), with no other zones participating.

The current full scope association financial examination covered the period from January 1, 2005, through December 31, 2007, and was conducted by examiners from the State of Missouri, representing the Midwestern Zone of the NAIC, with no other zones participating.

This examination also included the material transactions and/or events occurring subsequent to the examination date, which are noted in this report.

### **Procedures**

This examination was conducted using the guidelines set forth in the Financial Condition Examiners Handbook of the NAIC, except where practices, procedures and applicable regulations of the Missouri Department of Insurance, Financial Institutions and Professional Registration (DIFP) and statutes of the State of Missouri prevailed.

The examiners relied upon information supplied by the Company's independent auditor, Deloitte & Touche, LLP, of Kansas City, Missouri, for its audit covering the period from January 1, 2006, through December 31, 2006. Information relied upon included fraud risk assessment and legal representation letters. Our examination also relied on legal representation letters provided by the independent auditor, Williams-Keepers, LLC, of Columbia, Missouri, for its audit covering the period from January 1, 2007 to December 31, 2007.

### **Comments - Previous Examination**

The previous financial examination of CNIC was conducted by the Missouri DIFP for the period ending December 31, 2004. Listed below are the comments, recommendations, and notes from the previous examination report, the Company's response, and the findings in the current examination.

#### **Conflict of Interest Disclosure Statements**

*Comment:* It was stated that conflict of interest statements were not completed for the years under examination, from 2002 to 2004, but were completed in 2005. It was recommended that the Company ensure that officers, directors and key employees complete conflict of interest disclosure statements annually.

*Company's Response:* The Company stated that it would ensure that officers, directors and key employees complete conflict of interest disclosure statements continuing in 2006 and thereafter.

*Current Findings:* Conflict of interest statements were properly completed by officers and directors during the examination period.

**Reserving Practices**

*Comment:* It was recommended that the Company implement the recommendations from the consulting actuary engaged by the Missouri DIFP. These recommendations were as follows: (1) the Company should closely monitor case reserve adequacy, and (2) the Company should separately track and analyze new or different lines of business (e.g., Florida) in order to identify and react to issues arising from changes in development.

*Company's Response:* The Company stated that (1) it has and will continue to monitor case reserve adequacy; and (2) it will separately track and analyze new states (e.g., Florida) or different lines of business in order to identify and react to issues from changes in development.

*Current Findings:* The Missouri DIFP consulting actuary for the current examination did not have any recommendations pertaining to case reserves. The consulting actuary noted that the Company's actuary continues to combine business segments in the actuarial analysis instead of analyzing the segments separately. However, the Missouri DIFP consulting actuary found that there were data reconciliation issues that prohibited the segment analysis by the Company's actuary. It was also noted that the Company's actuary appropriately made manual adjustments to account for differences in business segments.

Further, the Company's business plan has changed significantly in 2008, which should alleviate the need for actuarial analysis on a segment basis. Refer to the Insurance Products and Related Practices section of this report for further information on operational changes in 2008.

**Netting of Assets and Liabilities**

*Comment:* It was stated that the Company incorrectly netted commissions payable into the uncollected premiums line of the 2004 Annual Statement. SSAP No. 64 prohibits such treatment when no legal right of offset exists. It was recommended that the Company ensure that netting entries are only made when a legal right of offset exists.

*Company's Response:* The Company stated that it would ensure that commissions payable will not be netted against uncollected premiums, beginning with the 2006 Quarterly and Annual Statements.

*Current Findings:* The Company did not net any commissions payable into the uncollected premiums line of the 2006 Annual Statement. However, some commissions payable were netted into the uncollected premiums line of 2007 Annual Statement. It was determined that the current agreements with certain managing general agents allow for the contractual right of offset and therefore, the commissions payable were properly netted in 2007.

## HISTORY

### General

The Company was incorporated on March 6, 1997 and commenced business on March 19, 1997. The Company operates as a stock property and casualty insurer under the insurance laws of Chapter 379 RSMo (Insurance Other Than Life).

### Capital Stock

As of the examination date, the Company's Articles of Incorporation allowed for the issuance of 23,500 shares of common stock with a par value of \$100 per share. As of December 31, 2007, all 23,500 shares were issued and outstanding to Cornerstone Management Partners, Inc. (CMP) for a total capital stock balance of \$2,350,000.

The Articles of Incorporation were amended on August 26, 2005 to increase the total amount of authorized common stock from 12,000 to 15,000 shares. A stock dividend of 3,000 shares was issued to CMP on August 29, 2005. The Articles of Incorporation were amended on May 12, 2006 to increase the total amount of authorized common stock from 15,000 to 23,500 shares. A stock dividend of 8,500 shares was issued to CMP on November 16, 2006. This increased the total shares issued and outstanding to 23,500 and increased the total capital stock balance to \$2,350,000.

### Dividends

There were no cash dividends declared or paid during the examination period. Stock dividends were issued in 2005 and 2006, as explained in the Capital Stock section above.

### Management

The management of the Company is vested in a Board of Directors which is appointed by the shareholders. The Company's Bylaws specify that the Board of Directors shall consist of fourteen members. The Board of Directors appointed and serving, as of December 31, 2007, were as follows:

<u>Name</u>	<u>Address</u>	<u>Principal Occupation and Business Affiliation</u> <sup>1</sup>
James C. French <sup>2</sup>	Columbia, MO	Chairman, President and Chief Exec. Officer
Daniel H. Allen	Hartsburg, MO	Senior Vice President and Underwriting Auditor
D. Scott Forrest	Columbia, MO	Vice President and General Counsel
Brian G. Harrison	Columbia, MO	Owner / Producer, Harrison Agency, Inc.
Earl P. Holland <sup>2</sup>	Fort Myers, FL	Retired / Private Investor
Dale W. Hotze	Mission Hills, KS	Consultant / Owner, AMF International, Inc.
Andrew R. Gingrich	Columbia, MO	CFO and Treasurer, MBS Textbook Exchange, Inc.

James E. Godfrey, Jr.	St. Louis, MO	Assoc. Attorney, Godfrey, Vandover & Burns, Inc.
Roger G. McKee	Columbia, MO	Vice President, Life Brokerage
Robert W. Reid	Columbia, MO	Vice President, Public Relations
Kirk W. Schmidt	Jefferson City, MO	Vice President, Chief Financial Officer, Treasurer
Roger W. Thomas	Columbia, MO	Retired
Roger D. Walker	Columbia, MO	Senior VP and Chief Operating Officer
John W. Wooldridge	Columbia, MO	Secretary and Vice President, Midwest Marketing

<sup>1</sup> Directors employed by Cornerstone Management Partners, Inc., unless otherwise noted.

<sup>2</sup> Mr. Holland was elected Chairman of the Board, effective March 7, 2008. Mr. French remained as the President and Chief Executive Officer.

### Committees

The Articles of Incorporation and Bylaws do not require any committees, but the Bylaws do allow for the creation of committees, if authorized by a resolution of the Board of Directors. The Company did not have any appointed committees, as of December 31, 2007. However, the parent company, CMP, had committees established throughout the exam period that regularly address and take actions on the business affairs of CNIC. The CMP committees appointed and serving, as of December 31, 2007, were as follows:

#### Nominating Committee

James C. French  
Roger D. Walker  
Earl P. Holland

#### Executive Compensation Committee

Earl P. Holland  
Roger W. Thomas  
James E. Godfrey, Jr.

#### Audit Committee

Dale W. Hotze  
Andrew R. Gingrich

### Officers

The officers elected by the Board of Directors and serving as of December 31, 2007, were as follows:

<u>Officer</u>	<u>Position</u>
James C. French <sup>3</sup>	Chairman, President and Chief Executive Officer
Daniel H. Allen	Senior Vice President and Underwriting Auditor
Michael K. Block	Vice President, Underwriting
D. Scott Forrest	Vice President and General Counsel
Craig A. Van Matre	Assistant Secretary
Robert W. Reid	Vice President, Public Relations
Kirk W. Schmidt <sup>4</sup>	Vice President, Chief Financial Officer, Treasurer
Roger D. Walker	Senior VP and Chief Operating Officer

John W. Wooldridge

Secretary and Vice President, Midwest Marketing

<sup>3</sup> Mr. French elected President and Chief Executive Officer only, effective March 7, 2008. Mr. French elected Chief Executive Officer only, effective June 6, 2008.

<sup>4</sup> Mr. Schmidt elected President, effective June 6, 2008.

### **Conflict of Interest**

The Company has a policy that requires all officers, directors, and certain designated employees to complete a conflict of interest statement each year. The responses to the conflict of interest statements were reviewed for the examination period. No significant exceptions were noted.

### **Corporate Records**

A review was made of the Articles of Incorporation and Bylaws for the examination period. There were no amendments or changes to the Bylaws during the period under examination.

The Company amended its Articles of Incorporation twice during the examination period. Both amendments were made to increase the authorized number of shares of common stock and are described further in the Capital Stock section of this report.

The minutes of the Board of Directors' meetings, stockholder's meetings, and CMP committee meetings were reviewed for proper approval of corporate transactions. In general, the minutes appear to properly reflect and approve the Company's major transactions and events for the period under examination.

### **Acquisitions, Mergers and Major Corporate Events**

None during the examination period.

### **Surplus Debentures**

A surplus note with a face amount of \$5,000,000 was issued on July 7, 2004 to Dekania CDO II, Ltd. The principal balance is due thirty (30) years after the issue date. The interest payable each quarter is based upon the 3-month LIBOR plus 4.2%, which equaled an annual rate of 9.07%, as of December 31, 2007. Interest and principal payments may only be made with the prior approval of the Director of the DIFP. Total interest paid for the surplus note during the examination period was \$1,448,228.

A request by the Company to pay \$115,878 for surplus note interest due on February 15, 2008 was denied by the Missouri DIFP. The interest payment was subsequently paid by the parent, CMP. This transaction was approved by the Missouri DIFP, under the condition that the Company is in no way liable to CMP for the amount paid.

## AFFILIATED COMPANIES

### **Holding Company, Subsidiaries and Affiliates**

The Company is a member of an Insurance Holding Company System as defined by Section 382.010, RSMo (Definitions). An Insurance Holding Company System Registration Statement was filed by CNIC for each year of the examination period.

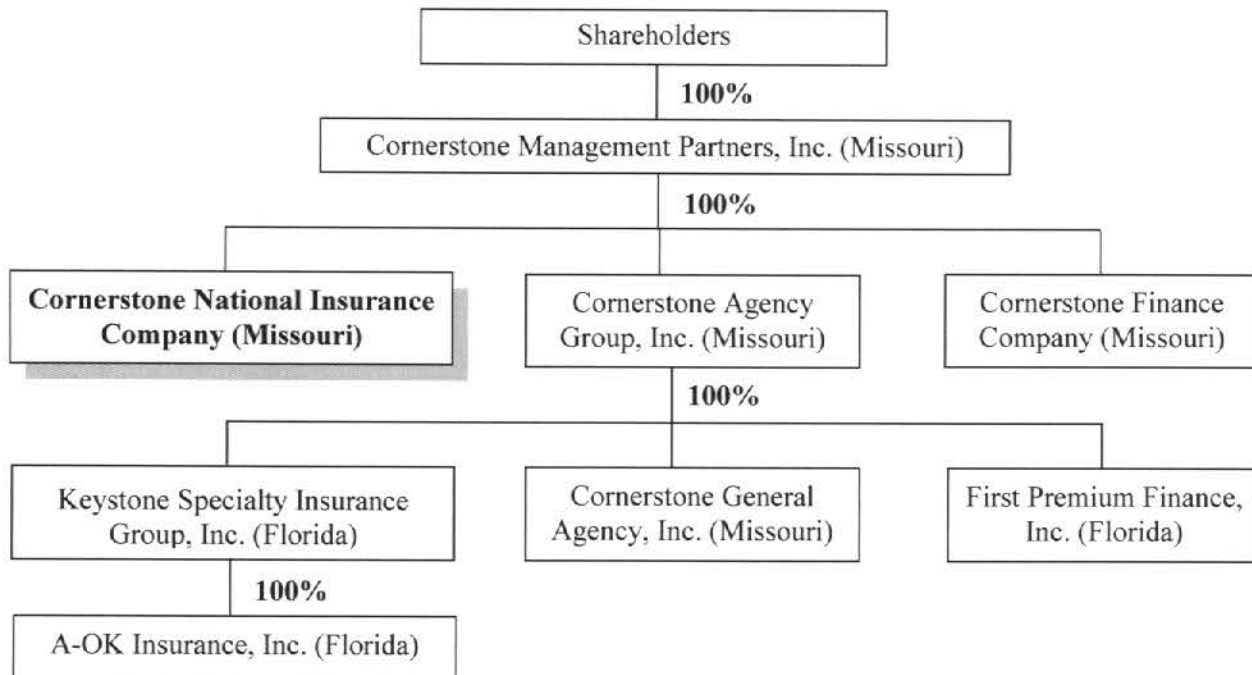
The Company is directly owned 100% by Cornerstone Management Partners, Inc. (CMP), a holding company. CMP is a privately held stock company with approximately 300 shareholders. The largest shareholder of CMP is James French, the President and Chief Executive Officer of CNIC. Mr. French owned 14% of the outstanding stock of CMP, as of December 31, 2007. Collectively, management of CNIC owns approximately 36% of CMP.

CMP has several other subsidiaries, most of which have business operations in support of the insurance business of CNIC. CMP and its subsidiaries are collectively referred to as the Cornerstone Group. CNIC is by far the largest entity in the Cornerstone Group. A description of the business operations of CMP and its subsidiaries are as follows:

- Cornerstone Management Partners, Inc. – Its employees perform the day-to-day business operations of CNIC. It also serves as a managing general agency for the marketing of life and health insurance and annuities, and property and casualty products which CNIC does not write.
- Cornerstone Finance Company – Lends money to persons, partnerships, associates, and corporations for the financing of commercial insurance premiums, mobile homes, and other purposes.
- Cornerstone Agency Group, Inc. – A holding company with no operations.
- Cornerstone General Agency, Inc. – An agency that places the other insurance risks of the insureds of CNIC, such as homeowners insurance and life products.
- First Premium Finance, Inc. – A shell company, as of December 31, 2007.
- Keystone Specialty Insurance Group, Inc. (Keystone) – A managing general agent that marketed and serviced the Company's non-standard auto policies in Florida and Texas. The parent, CMP, had a letter of intent to sell Keystone during 2008, but the sale was never finalized. Keystone's operations were shut down at the end of April 2008 and it is currently in run-off.
- A-OK Insurance, Inc. (A-OK) – A managing general agent that marketed and serviced the Company's policies and other insurance companies' policies in Florida. Most of A-OK's assets were sold in late 2007 and it was only a shell entity, as of December 31, 2007. CMP plans to liquidate A-OK in the near future.

**Organizational Chart**

The following table depicts the ownership and affiliates of the Company, as of December 31, 2007:

**Intercompany Transactions**

The Company's intercompany agreements in effect, as of December 31, 2007 and subsequent periods, are outlined below.

**1. Type:** Management Agreement

**Affiliate:** Cornerstone Management Partners, Inc.

**Effective:** March 19, 1997

**Terms:** CMP will provide the following management services for CNIC: Claims adjusting and settlement, underwriting, loss management, policyholder services, marketing, accounting and tax reporting, actuarial, legal, human resources, investments, administration, strategic planning, billing and collection, information technology, data processing, regulatory and compliance, and public relations. Compensation for the services provided are separated into different categories. Allocation of salaries and benefits of CMP employees are based upon a Schedule A attached to the Agreement. Overhead costs for rent and utilities will be charged 89% to CNIC. The Company will pay the actual cost for telephone usage, copies, postage, travel, information services and data

processing. Depreciation charged for CMP's computer hardware and software used for CNIC is to be based upon a three year depreciation period.

**Exception:** The actual costs allocated to CNIC for salary and benefit costs of CMP employees during the exam period were different from the allocation percentages in Schedule A. The original Schedule A has become outdated due to changes in personnel over the years and organizational changes. The actual costs allocated by CMP appear to be based upon a reasonable methodology. However, there is no contractual basis to support the allocation percentages that are currently in use. The Company should amend the Management Agreement to either include the current allocation percentages for CMP personnel or state that the allocation of payroll and benefit costs will be based upon the estimated percentages of each employees time spent on CNIC operations.

**2. Type:** Tax Allocation Agreement

**Affiliate:** Cornerstone Management Partners, Inc., Cornerstone Finance Company, Cornerstone Agency Group, Inc., Cornerstone General Agency, Inc., First Premium Finance, Inc., and Keystone Specialty Insurance Group, Inc.

**Effective:** October 4, 2006

**Terms:** All of the parties to the Agreement will annually file a consolidated federal income tax return commencing with the 2000 tax year. Each entity's share of the consolidated tax liability or refund shall be calculated as the amount that would have been incurred if each entity would have filed a tax return on a stand-alone basis. The settlements of tax payments due to CMP are to be paid within 30 days of the date that each filing is due to the Internal Revenue Service (IRS). Any tax refunds receivable from CMP are due within 30 days of CMP's receipt of the funds from the IRS.

**3. Type:** Managing General Agency Agreement

**Affiliate:** Keystone Specialty Insurance Group, Inc.

**Effective:** December 1, 2005 to December 1, 2008

**Terms:** Keystone has the authority to issue insurance policies on behalf of CNIC. The authorized business that Keystone may write is private passenger auto liability, auto physical damage, and other related auto coverages in the states of Florida, Missouri, and Texas only. Keystone will collect all premiums for the subject policies. The collected premiums, less the commissions due to Keystone, are to be deposited in premium trust account that will be held by Keystone in a fiduciary capacity on behalf of CNIC. Keystone is also authorized to settle and pay claims. The investment earnings on the funds in the premium trust account will be retained by Keystone.

The commissions received by Keystone started at 20% of Florida and Missouri written premiums and 22.5% of Texas written premiums. Effective October 1, 2007, the commission rate was reduced to 19% for Florida business.

This agreement will not be renewed, since Keystone has ceased operations, effective April 30, 2008.

### **Intercompany Payments**

The following table summarizes the payments made during the examination period, between CNIC and its affiliates, pursuant to intercompany agreements and other transactions.

Affiliate	Agreement / Transaction	Net Paid / (Received)		
		2005	2006	2007
CMP	Management	\$3,543,147	\$3,989,826	\$4,939,412
CMP	Tax Allocation	76,539	483,847	(448,078)
Keystone Specialty	MGA Agreement	10,979	555,667	2,617,755
CMP	Capital Contribution	(949,705)	0	0
<b>TOTAL</b>		<b>\$2,680,960</b>	<b>\$5,029,340</b>	<b>\$7,109,089</b>

### **FIDELITY BOND AND OTHER INSURANCE**

The Company's parent, CMP, is a named insured on a financial institution bond that covers losses resulting from dishonest or fraudulent acts of employees. The bond covers all subsidiaries of CMP, including CNIC. The bond has a liability limit of \$500,000 with a \$10,000 deductible, which meets the minimum coverage recommended by the NAIC. The Company is also a named insured on the following insurance policies: property, general liability, and commercial excess and umbrella liability. Directors' and officers' liability insurance for CNIC is provided through a policy issued to CMP, which covers all of its subsidiaries.

### **PENSION, STOCK OWNERSHIP AND INSURANCE PLANS**

CNIC does not have any direct employees and thus, does not directly incur or accrue any expenses for employee benefits. Most of the Company's daily business operations are conducted by the employees of the parent company, Cornerstone Management Partners, Inc. An allocated portion of the payroll and benefit costs of CMP employees are paid by CNIC pursuant to a Management Agreement, which is described in the Intercompany Transactions section of this report.

## STATUTORY DEPOSITS

### Deposits with the State of Missouri

The funds on deposit with the Missouri DIFP, as of December 31, 2007, were sufficient to meet the capital deposit requirements for the State of Missouri in accordance with Section 379.098 RSMo (Securities to be Deposited). The funds on deposit as of December 31, 2007, were as follows:

<u>Type of Security</u>	<u>Par Value</u>	<u>Fair Value</u>	<u>Statement Value</u>
Municipal Bonds	\$2,060,000	\$2,014,111	\$2,053,551

### Deposits with Other States

The Company also has funds on deposit with other states. Those funds on deposit, as of December 31, 2007, were as follows:

<u>State</u>	<u>Type of Security</u>	<u>Par Value</u>	<u>Fair Value</u>	<u>Statement Value</u>
Arkansas	Municipal Bonds	\$150,000	\$147,270	\$148,483
Georgia	Municipal Bonds	35,000	34,424	34,646
Louisiana	Municipal Bonds	20,000	20,000	20,056
Oklahoma	Municipal Bonds	350,000	347,841	249,326
Virginia	Municipal Bonds	<u>250,000</u>	<u>246,785</u>	<u>347,720</u>
<b>Total</b>		<u>\$805,000</u>	<u>\$796,320</u>	<u>\$800,231</u>

## INSURANCE PRODUCTS AND RELATED PRACTICES

### Territory and Plan of Operation

CNIC is licensed as a property and casualty insurer by the Missouri DIFP under Chapter 379 RSMo (Insurance Other than Life). As of December 31, 2007, the Company was licensed in a total of eighteen states, but only wrote business in ten of those states during 2007. The Company was also issued a certificate of authority during 2008 to write business in Utah and had a pending application for a license in New Mexico, as of the date of this report.

The following four states comprised 81% of the total 2007 direct written premiums: Missouri (32% of total), Florida (25%), Arkansas (14%), and Oklahoma (13%). The Company's only lines of business with net retained risks are automobile liability and automobile physical damage. Crop insurance is also written in Louisiana that is 100% reinsured.

The Company's business model, as of December 31, 2007, consisted of three segments, as follows:

- The Core business segment writes standard and preferred auto risks in Arkansas, Kansas, Missouri, Oklahoma and Texas. Approximately 700 independent agents produce the Core business, which accounted for 70% of net written premiums in 2007.
- The Specialty segment writes non-standard auto risks in Florida and Texas that are produced by two Managing General Agents (MGAs). An affiliate, Keystone Specialty Insurance Group, and an unaffiliated entity, National Insurance Service Plan, are the two entities that produce the Specialty business. The Specialty segment represented 30% of net written premiums in 2007.
- The Program segment has non-standard auto business in Arizona, California, Colorado, Florida and Georgia (beginning in 2008) and also includes crop risks in Louisiana and the National Flood Insurance Program in various states. The Company has several MGA agreements for the Program segment, which has little retained risk for CNIC.

The Company had a net loss of \$3.6 million in 2007 and an overall decrease of \$4.7 million in capital and surplus. These losses were in addition to a nearly \$1.0 million decrease in capital and surplus in 2006. The disappointing financial results were due mostly to losses in Florida from the Specialty segment.

Changes were made to the business plan in 2008 in response to the losses experienced in 2006 and 2007. The most significant changes affected the Specialty segment, which will be eliminated. The ceding percentages for the Specialty segment were increased, effective April 1, 2008, to 90% for the Keystone business and 100% for the NISP business. Further, the operations of the Keystone MGA were shut down, effective April 30, 2008, and that business is currently in run-off status. The remaining NISP business will be folded into the Program segment, which includes other fronting arrangements that are reinsured either 90% or 100%. CNIC is currently focusing most of its efforts on the Core business in the Midwest.

**Policy Forms & Underwriting**  
**Advertising & Sales Materials**  
**Treatment of Policyholders**

The Missouri DIFP has a market conduct staff that performs a review of these issues and generates a market conduct report. The most recent market conduct examination report covered the period from January 1 through December 31, 2004 and was issued in May 2005. The report did not disclose any control weaknesses or statutory violations that would materially impact the Company's financial condition.

## REINSURANCE

### General

The Company's premium activity on a direct written, assumed and ceded basis, for the period under examination, is detailed below:

	<u>2005</u>	<u>2006</u>	<u>2007</u>
Direct Business	\$30,526,601	\$55,109,481	\$55,932,862
Reinsurance Assumed	0	0	0
Reinsurance Ceded:			
Affiliates	0	0	0
Non-affiliates	<u>(5,620,734)</u>	<u>(22,163,931)</u>	<u>(14,934,034)</u>
<b>Net Premiums Written</b>	<b><u>\$24,905,867</u></b>	<b><u>\$32,945,550</u></b>	<b><u>\$40,998,828</u></b>

### Assumed

CNIC did not assume any premiums during the exam period and there are no plans to assume business in the future.

### Ceded

The Company has a quota share reinsurance agreement, effective from April 1, 2007 to March 31, 2008 with Dorinco Reinsurance Company (50% participation), NGM Insurance Company (25% participation), and SCOR Reinsurance Company (25% participation). The agreement covers all standard or preferred auto policies and the non-standard or specialty auto policies written by an affiliated Managing General Agent (MGA), Keystone Specialty Insurance Group, Inc., and an unaffiliated MGA, National Insurance Services Plan, Inc. The reinsurers are ceded 15% of preferred risks and 25% of specialty risks for the subject policies.

The Company has a two-layer property catastrophe agreement, effective from April 1, 2007 to March 31, 2008 with R+V Versicherungs AG (25% participation) and various Lloyd's syndicates (75% participation). The first layer cedes 95% of the next \$700,000 of losses in excess of a \$500,000 retention for CNIC per occurrence. The second layer cedes 95% of the next \$600,000 of losses in excess of a retention of \$1,200,000 per occurrence. Hail storms are the Company's main catastrophe risk.

The Company has a two-layer casualty excess of loss agreement, effective from April 1, 2007 to March 31, 2008 with various reinsurers. The largest participating reinsurer is Platinum Underwriters Reinsurance, Inc., which has a 70% share of the first layer and a 75% share of the second layer. The first layer cedes 100% of the next \$1,000,000 of liability losses in excess of a

\$500,000 retention for CNIC per occurrence. The second layer cedes 100% of the next \$5,500,000 of liability losses in excess of a retention of \$1,500,000 per occurrence.

The Company also has several quota share agreements for the fronting programs written by various general agents. The fronting programs involve non-standard auto business, crop insurance, and national flood insurance. The business from these programs are ceded either 90% or 100%, depending on the program and the territory.

The Company has obtained agreements for the subsequent treaty year, beginning April 1, 2008 and ending March 31, 2009. The written agreements had not been signed by the reinsurers, as of the date of this report. However, the agreed upon terms were provided by the Company management during our examination.

The 2008-09 quota share agreement covering most of the Company's business will cede a minimum of 90% of the non-standard or specialty policies, in comparison to only 25% that was ceded for the 2007-08 treaty year. The large increase in the ceding percentage was in response to poor underwriting results from the specialty segment during 2007. The standard or preferred business will be ceded at 26.25% for 2008-09, in comparison to only 15% that was ceded for the 2007-08 treaty year. The preferred business has been profitable, but the ceding percentage was increased to reduce the level of net written premiums and improve the premium to surplus ratio.

The coverage change to the 2008-09 casualty excess of loss agreement was a decrease to \$5,000,000 for the maximum losses subject to reinsurance, in comparison to a \$7,000,000 maximum for the prior treaty year. There were no changes in the property catastrophe coverage limits from the prior year. Both the casualty excess of loss and the property catastrophe coverages will continue to have a retention of \$500,000 per occurrence.

The Company is contingently liable for all reinsurance losses ceded to others. This contingent liability would become an actual liability in the event that an assuming reinsurer fails to perform its obligations under the reinsurance agreement.

## **ACCOUNTS AND RECORDS**

The CPA firm, Deloitte & Touche, LLP, in Kansas City, Missouri, issued audited statutory financial statements of the Company for years ending December 31, 2005 and December 31, 2006. A new CPA firm, Williams-Keepers, LLC, in Columbia, Missouri, issued the audited financial statements for the year ending December 31, 2007.

The actuarial opinion regarding the Company's reserves for losses and loss adjustment expenses (LAE) was issued by Mark A. Doepke, FCAS, MAAA, of Actuarial Advisors, Inc. in Minneapolis, Minnesota, for all years in the examination period.

During our examination, there were numerous instances in which the Company could not properly reconcile a general ledger account balance or could not provide records to properly support information reported in the 2007 Annual Statement. Examples of these problems are listed below.

- There were several variances between lists of the policy-by-policy records provided to support the Uncollected Premiums asset and the amount reported in the Annual Statement. The variances by segment were (1) over \$100,000 for the core business, (2) \$65,000 for the MGA business from NISP, and (3) nearly a \$200,000 variance for the MGA business from Keystone.
- There was approximately a \$200,000 variance between a list of the policy-by-policy records provided to support the Unearned Premiums liability and the amount reported in the Annual Statement.
- Data records provided for the case reserves for losses and loss adjustment expenses varied by approximately \$1 million between loss years in comparison to the reserves reported in Schedule P of the Annual Statement. The net variance was \$207,000.
- Adequate reconciliations could not be provided for some of the account balances included in the Amounts Recoverable from Reinsurers line and the Ceded Reinsurance Premiums Payable line. A large reconciling problem for the Ceded Reinsurance Premiums Payable line is also explained in the Notes to the Financial Statements section.
- An uncollectible asset of \$140,628 pertaining to transactions with NISP was imbedded in the Aggregate Write-In Liabilities line. This asset resulted from numerous unexplained accounting differences that accumulated over a three year period. These differences were undetected until our examination and now must be written off as a reduction to capital and surplus.

Additional details on the items listed above have been communicated to CNIC in a management letter that was previously provided. Although some of the problems are not material, the number of instances where we experienced accounting problems is a concern. These accounting problems appear to be due to the following three conditions.

The Company does not regularly reconcile its general ledger accounts. It was explained by management that CNIC does not have enough resources to perform account reconciliations. This is a control deficiency that creates uncertainties about the accuracy of the Company's financial statements and could lead to material errors in the financial statements. Most insurance companies reconcile balance sheet accounts on a monthly basis. It is recommended that the Company devote resources to reconcile its general ledger accounts for the balance sheet on at least a quarterly basis. Proper reconciliations should only include the outstanding items that comprise an account balance.

The Company has a policy administration system that does not properly interface with the accounting system used to maintain the general ledger. The Company should investigate ways to eliminate the problems between the two computer systems. Management should also consider replacing one or both computer systems if the problems cannot be resolved.

CNIC does not properly save year-end data in its computer system, which would provide policy level detail to support general ledger balances. The computer system also does not have the capability to extract point-in-time data after the date of the reporting period. During our examination, supporting data records, as of December 31, 2007, were apparently affected by 2008 transactions that led to an inability to reconcile the account balances. The Company should save the critical data on at least a quarterly basis for items such as in-force policies and premiums, unearned premiums, paid claims, and unpaid claims. This data is essential to provide a proper audit trail to support the amounts reported on the Quarterly and Annual Statements.

### **FINANCIAL STATEMENTS**

The following financial statements, with supporting exhibits, present the financial condition of Cornerstone National Insurance Company for the period ending December 31, 2007. Any examination adjustments to the amounts reported in the financial statements and/or comments regarding such are made in the "Notes to the Financial Statements." The failure of any column of numbers to add to its respective total is due to rounding or truncation.

There may have been additional differences found in the course of this examination, which are not shown in the "Notes to the Financial Statements." These differences were determined to be immaterial concerning their effect on the financial statements, and therefore, were only communicated to the Company and noted in the workpapers for each individual Annual Statement item.

**Assets**  
**as of December 31, 2007**

	<u>Assets</u>	Non- Admitted <u>Assets</u>	Net Admitted <u>Assets</u>
Bonds	\$30,028,637	\$ 0	\$30,028,637
Common Stocks	2,501,097	0	2,501,097
Cash and Short-Term Investments	2,044,697	0	2,044,697
Other Invested Assets	588,816	0	588,816
Investment Income Due and Accrued	317,257	0	317,257
Uncollected Premiums and Agents' Balances	9,383,334	0	9,383,334
Deferred Premiums	0	0	0
Amounts Recoverable from Reinsurers	1,759,623	0	1,759,623
Federal Income Tax Recoverable	2,099,442	2,099,442	0
Net Deferred Tax Asset	<u>1,026,090</u>	<u>0</u>	<u>1,026,090</u>
<b>TOTAL ASSETS</b>	<b><u>\$49,748,993</u></b>	<b><u>\$2,099,442</u></b>	<b><u>\$47,649,551</u></b>

## Liabilities, Surplus and Other Funds as of December 31, 2007

Losses	\$12,557,768
Loss Adjustment Expenses	3,190,845
Commissions Payable	1,401,323
Other Expenses	67,122
Taxes, Licenses and Fees	310,825
Unearned Premiums	12,636,143
Advance Premium	416,608
Ceded Reinsurance Premiums Payable ( <b>Note 1</b> )	3,119,347
Payable to Parent, Subsidiaries and Affiliates	173,246
Aggregate Write-In Liabilities:	0
Paid Losses and LAE Payable to Florida MGA	<u>737,759</u>
<b>TOTAL LIABILITIES</b>	<b>\$34,610,986</b>
Common Capital Stock	2,350,000
Surplus Notes	5,057,146
Gross Paid In and Contributed Surplus	13,224,342
Unassigned Funds (Surplus)	<u>(7,592,923)</u>
Capital and Surplus	<b><u>\$13,038,565</u></b>
<b>TOTAL LIABILITIES AND SURPLUS</b>	<b><u>\$47,649,551</u></b>

## Summary of Operations

### For the Year Ended December 31, 2007

<b>Premium Earned</b>	<b>\$39,384,957</b>
DEDUCTIONS:	
Losses Incurred	27,000,713
Loss Expenses Incurred	5,598,907
Other Underwriting Expenses Incurred	<u>13,977,946</u>
<b>Total Underwriting Deductions</b>	<b><u>\$46,577,566</u></b>
<b>Net Underwriting Gain</b>	<b>(\$7,192,609)</b>
Net Investment Income Earned	910,801
Net Realized Capital Gains	<u>73,016</u>
<b>Net Investment Gain</b>	<b><u>\$983,817</u></b>
Other Income	539,182
Federal Income Taxes Incurred	<u>(2,099,415)</u>
<b>Net Income</b>	<b><u>(\$3,570,195)</u></b>
<b>CAPITAL AND SURPLUS ACCOUNT:</b>	
Surplus as Regards Policyholders, December 31, 2006	\$17,702,329
Net Income	(3,570,195)
Change in Net Unrealized Capital Gains or (Losses)	186,218
Change in Net Deferred Income Tax	297,336
Change in Non-Admitted Assets	(2,099,442)
Change in Surplus Notes	(4,020)
Aggregate Write-Ins for Gains and Losses in Surplus:	
Accrued But Unapproved Interest on Surplus Note	4,020
Prior Period Adjustment	<u>522,319</u>
<b>Surplus as Regards Policyholders, December 31, 2007</b>	<b><u>\$13,038,565</u></b>

## Notes to the Financial Statements

### Note 1 – Ceded Reinsurance Premiums Payable

**\$3,119,347**

The Company could not reconcile \$1.3 million of the total reported balance of \$3.1 million. The unreconciled amount of \$1.3 million was originally explained to be related to the quota share reinsurance agreements for the treaty year beginning April 1, 2006 and ending March 31, 2007 (T10) and the treaty year beginning April 1, 2007 and ending March 31, 2008 (T11). The Company's original explanation was that premiums payable of \$0.5 million for the T10 treaty year and ceding commissions payable of \$0.8 million for the T10 and T11 treaty years made up the unreconciled balance.

Management later provided a different explanation that the \$1.3 million was a liability only for ceding commissions payable, which consisted of \$1.0 million for the T10 and T11 treaty years and \$0.3 million for several other prior treaty years. CNIC's quota share agreements provide for the Company to receive provisional ceding commissions each month. The provisional commission rate is adjusted upward or downward on a sliding scale basis depending upon the actual loss ratio for each treaty year. For example, CNIC received provisional ceding commissions of 28% for the T10 and T11 treaty years. Due to poor underwriting results for both of these years, the adjusted commission rate will be reduced to 20% for the T10 treaty year and 23% for the T11 treaty year. The ceding commission adjustment is made once each year on the anniversary of the ending effective date. Thus, the first ceding commission adjustment for the T10 treaty year will be paid shortly after March 31, 2008 and the first adjustment for the T11 treaty year will be paid shortly after March 31, 2009.

The Company's explanations and calculations for the ceding commissions payable of \$1.3 million appear reasonable. However, the problem remains that over a period of time, the Company recorded \$1.3 million of entries in the general ledger, which could not be reconciled. It is recommended that the Company's management perform in-depth research into the unreconciled balances in the Ceded Reinsurance Premiums Payable line. Proper write-offs or adjusting entries should be made to "clean-up" the applicable general ledger accounts after the research is completed.

## Examination Changes

None.

## General Comments and/or Recommendations

### Management Agreement (pages 8 and 9)

The actual costs allocated to CNIC for salary and benefit costs of CMP employees during the examination period were different from the allocation percentages in Schedule A of the Management Agreement with CMP. The original Schedule A has become outdated due to changes in personnel over the years and organizational changes. The actual costs allocated by CMP appear to be based upon a reasonable methodology. However, there is no contractual basis to support the allocation percentages that are currently in use. The Company should amend the Management Agreement to either include the current allocation percentages for CMP personnel or state that the allocation of payroll and benefit costs will be based upon the estimated percentages of each employees time spent on CNIC operations.

### Account Reconciliations and Records Maintenance (pages 15 and 16)

During our examination, there were numerous instances in which the Company could not properly reconcile a general ledger account balance or could not provide records to properly support information reported in the 2007 Annual Statement. These accounting problems appear to be due to the following three conditions.

The Company does not regularly reconcile all of its general ledger accounts. It was explained by management that CNIC does not have enough resources to perform account reconciliations. This is a control deficiency that creates uncertainties about the accuracy of the Company's financial statements and could lead to material errors in the financial statements. It is recommended that the Company devote resources to reconcile its general ledger accounts for the balance sheet on at least a quarterly basis.

The Company has a policy administration system that does not properly interface with the accounting system used to maintain the general ledger. The Company should investigate ways to eliminate the problems between the two computer systems. Management should also consider replacing one or both computer systems if the problems cannot be resolved.

CNIC does not properly save year-end data in its computer system, which would provide policy level detail to support general ledger balances. The computer system also does not have the capability to extract point-in-time data after the date of the reporting period. The Company should save the critical data on at least a quarterly basis for items such as in-force policies and premiums, unearned premiums, paid claims, and unpaid claims. This data is essential to provide a proper audit trail to support the amounts reported on the Quarterly and Annual Statements.

**Ceded Reinsurance Premiums Payable (page 20)**

The Company could not reconcile \$1.3 million of the total reported balance of \$3.1 million. We were provided with conflicting explanations on the nature of the items that comprise this amount. It was ultimately explained that ceding commissions payable represents the bulk of \$1.3 million at issue. However, a precise reconciliation was never provided. The Company's revised explanations and calculations appear reasonable. However, the problem remains that over a period of time, the Company recorded \$1.3 million of entries in the general ledger, which could not be reconciled. It is recommended that the Company's management perform in-depth research into the unreconciled balances in the Ceded Reinsurance Premiums Payable line. Proper write-offs or adjusting entries should be made to "clean-up" the applicable general ledger accounts after the research is completed.

### **SUBSEQUENT EVENTS**

CNIC's Quarterly Statement, as of March 31, 2008, reported a net loss of \$472,536 for the first quarter of 2008. An unrealized loss of \$330,350 on the common stock investments was also reported during the first quarter of 2008. Overall, capital and surplus decreased by \$1,167,963 or 9%, from \$13,038,565 on January 1, 2008, to \$11,870,602 on March 31, 2008.

**ACKNOWLEDGMENT**

The assistance and cooperation extended by the officers and the employees of Cornerstone National Insurance Company during the course of this examination is hereby acknowledged and appreciated. In addition to the undersigned, Shannon Schmoeger, CFE, Larry Kleffner, CFE, and Angela Campbell, CFE, CISA, examiners for the Missouri DIFP, participated in this examination. The firm of Expert Actuarial Services, LLC, also participated as a consulting actuary.

**VERIFICATION**

State of Missouri            )  
  )  
County of                    )

I, Tim L. Tunks, on my oath swear that to the best of my knowledge and belief the above examination report is true and accurate and is comprised of only facts appearing upon the books, records or other documents of Cornerstone National Insurance Company, its agents or other persons examined or as ascertained from the testimony of its officers or agents or other persons examined concerning its affairs and such conclusions and recommendations as the examiners find reasonably warranted from the facts.

Tim L. Tunks  
Tim L. Tunks, CPA, CFE  
Examiner-In-Charge  
Missouri DIFP

Sworn to and subscribed before me this 26th day of June, 2008.

My commission expires:

11/2/2008

Sheila M Burgess  
Notary Public  
Sheila M Burgess



### SUPERVISION

The examination process has been monitored and supervised by the undersigned. The examination report and supporting workpapers have been reviewed and approved. Compliance with NAIC procedures and guidelines as contained in the Financial Condition Examiners Handbook has been confirmed.

A handwritten signature in dark ink, reading "Vicki L. Denton", is written over a horizontal line.

Vicki L. Denton, CFE  
Audit Manager  
Missouri DIFP



August 27, 2008

Mr. Fred Heese  
Missouri Department of Insurance  
301 W. High St., Room 530  
Jefferson City, MO 65102-0690

Mr. Heese:

Please see the responses to the December 31, 2007 examination report recently completed by your staff. **I would like to have my responses included in the report as a public document.**

Management Agreement

We agree that an amendment of the agreement is necessary. The original agreement stated certain percentages based upon the employees at the time and the agreement needs to be amended to reflect the cost allocation methods that we are currently using. We are currently working on updating our cost allocation system and will file this agreement before finalizing this process.

Account Reconciliations and Records Maintenance

We agree that we do not reconcile all of our individual general ledger accounts; however, we do believe that we were able to adequately support all the balances as they were accumulated into the financial statements. It should be noted that we do perform monthly reconciliations of all of our bank accounts and tie our investment account balances into our general ledger, as well as having reconciliations on other balance sheet accounts. We also have many detailed spreadsheets that support general ledger balances. A very detailed review of all of our account balances was performed prior to finalizing the 2007 financial statements. We believe that we have a fairly detailed general ledger and doing a formal reconciliation on each general ledger account is not necessary; however, there are certain accounts and groups of accounts that we need to reconcile on a more frequent basis. We have already begun to do this and will continue to improve upon this in the future.

We also agree that our policy administration system does not directly interface with our general ledger; however we do take reports directly from this system to create our monthly accounting entries. Although there are some reports that the policy administration system creates that cannot be reconciled to the accounting records, we believe these differences are immaterial and have confidence

in our accounting records. The transactions recorded into our ledger for premium receipts and claims payments are based upon actual money received and paid, and therefore we believe that this provides a reliable basis for recording transactions. We have also taken over much of the maintenance of the policy administration system with in-house personnel. We believe that this will allow us to more thoroughly investigate differences in the information created by the policy administration system. If we cannot resolve these minor issues, we will look into a new general ledger system or policy management system in the future.

We also acknowledge because of the limitations of our policy administration system we need to have a list of reports that we run and save every month or quarter. We do this with the reports we use to book the monthly accounting entries but there also is a need to produce and save some other reports so that we can better perform periodic reconciliations and provide these reports to auditors as needed.

Ceded Reinsurance Premiums Payable

This item ties into the comments regarding reconciliations. There are many different general ledger accounts that are accumulated to produce this balance. During 2007, we changed the way that we settled certain ceding commission returns to the reinsurers because they were not being settled properly in the past. The general ledger accounts were accumulated by treaty year and when the settlement changes were made the accounts were not adjusted to reflect this. Therefore we were not able to reconcile amounts due for certain years to certain general ledger accounts. However; the total balance of all of these accounts was supported. We do acknowledge that we need to work on these accounts, make proper adjustments between accounts, and be able to perform a periodic reconciliation. We are in the process of developing a system to better track and monitor all of our reinsurance balances and reconcile these to the general ledger. This should be completed by year-end.

Please let me know if you have any additional questions about these responses. We appreciate the assistance and cooperation of your examination staff.

Sincerely,



Kirk W. Schmidt, CPA, CFE  
President and Treasurer  
Cornerstone National Insurance Company